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Russian Trade and Foreign Direct Investment Policy at the Crossroads

David Tarr
Natalya Volchkova

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Abstract

This paper summarizes the estimates of what Russia will get from World Trade Organization accession and why. A key finding is the estimate that Russia will gain about $53 billion per year in the medium term from World Trade Organization accession and $177 billion per year in the long term, due largely to its own commitments to reform its own business services sectors. The paper summarizes the principal reform commitments that Russia has undertaken as part of its World Trade Organization accession negotiations, and compares them with those of other countries that have acceded to the World Trade Organization. It finds that the Russian commitments represent a liberal offer to the members of the World Trade Organization for admission, but they are typical of other transition countries that have acceded to the World Trade Organization. The authors discuss the outstanding issues in the Russian World Trade Organizaiton accession negotiations, and explain why Russian accession will result in the elimination of the Jackson-Vanik Amendment against Russia. They discuss Russian policies to attract foreign direct investment, including an assessment of the impact of the 2008 law on strategic sectors and the increased role of the state in the economy. Finally, the authors assess the importance of Russian accession to Russia and to the international trading community, and suggestions for most efficiently meeting the government's diversification objective.

This paper—a product of the Trade and Integration Team, Development Research Group—is part of a larger effort in the department to assess the impact of liberalization of trade and foreign direct investment on growth and poverty reduction. Policy Research Working Papers are also posted on the Web at http://econ.worldbank.org. The author may be contacted at dtarr@worldbank.org.

Russian Trade and Foreign Direct Investment Policy at the Crossroads

David Tarr[1]

and

Natalya Volchkova[2]

[1] Consultant and former Lead Economist, The World Bank and adjunct Professor of Economics, the New Economic School in Moscow.

[2] Professor of Economics, the New Economic School in Moscow

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I. Introduction

As of June 2009, there were 153 member countries of the World Trade Organization (WTO). Trade among them represented 97 percent of the world's trade turnover, including over 94 percent of the foodstuffs. Russia is the largest economy outside the WTO and—along with Azerbaijan, Belarus, Kazakhstan, Tajikistan and Uzbekistan of the Commonwealth of Independent States (CIS)—is among the 29 countries that were attempting to accede to the WTO in August 2009.

The Working Party on accession of the Russian Federation to the WTO was established June 16, 1993. The WTO Working Party on Russia's accession comprises about 60 countries, and is the largest such Working Party in the history of the WTO. By the spring of 2007, Russia has successfully concluded bilateral agreements with all the members of its Working Party who sought a bilateral except Georgia.[3] The focus now is on the multilateral phase of the negotiations. Considerable progress on the multilateral issues was made so that by mid-2008, only three issues remained to be resolved; but these three issues remained on the table in mid-2009.

During the first Administration of President Vladimir Putin, Russia actively sought membership in the WTO, and this was seen as part of a strategy of an open economy model of economic development. As we discuss below, however, in recent years Russia, in its efforts to diversify the economy away from energy and raw material dependence, has employed several industrial policy and import-substitution-industrialization measures. We discuss why we believe that Russia's trade and foreign direct investment policies for the future are at a critical crossroads.

In section II, we summarize the estimates of what Russia will get from WTO accession and why. WTO accession is a long process--as mentioned Russia has been negotiating its accession since 1993. The Russian Duma has already passed into law about 42 significant packages of legislation to conform to WTO requirements,[4] and will implement selected other commitments on an agreed schedule up to several years after its actual accession. The studies mentioned below quantitatively

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[3] Georgia earlier had agreed to a bilateral agreement on Russian WTO accession but has withdrawn from that agreement.

[4] During the first Administration of President Vladimir Putin, the chief negotiator for WTO accession of the Russian Federation prepared a matrix of 42 packages of legislation that he needed to have prepared and passed by the Russian Duma in order to conform to WTO accession requirements.

estimate the collective impact of all these commitments taken during the long accession process. These studies estimate that Russia will gain about $40 billion per year in the medium term and $132 billion per year in the long term, due largely to its own commitments to reform in the business services sectors. In section III, we summarize the principal Russian reform commitments at the WTO, and compare those commitments in section IV to those of other acceding countries to the WTO. We find that the demands on Russia are comparable to other Transition countries. In section V, we discuss remaining issues in accession. In section VI, we discuss prospects for the Russia-Belarus-Kazakahstan customs union and related WTO accession issues. In section VII, we explain why Russian WTO accession will result in the elimination of the Jackson-Vanik Amendment against Russia. In section VIII, we discuss Russian policies to attract foreign direct investment. In section IX, we argue that uniform tariffs would yield substantial benefits for Russia, but pre-shipment inspection would yield marginal benefits at best. In the concluding section we argue that Russian WTO accession is crucial to Russia. The key point is that due to pressure from the international community, WTO accession represents a unique historical opportunity to overcome the usual domestic political economy forces that lead to excessive protection. On the other hand, the economic gains to the international community from Russian accession will likely be small. Finally, what is required for diversification is institutional reform to improve the business climate, especially for small and medium enterprises.

II. Estimates of WTO Accession Impacts on Russia: Russia will gain from $53 billion to $177 billion per year

WTO accession is a process that may be used as an important tool for economic development. WTO accession will impact on a wide range of policies and institutions, including tariff policy, customs administration, standards, rights of foreign investors (especially in services), agricultural policy, intellectual property and possibly government procurement. It therefore represents a time for evaluation of a very wide range of regulation and an opportunity to implement important trade, foreign direct investment and institutional changes.

As mentioned above, Russia has passed about 42 packages of legislation to conform to WTO requirements. In many cases, Russia has implemented changes prior to accession to adapt to post-WTO requirements; in other cases, the commitments may be implemented only several years after accession due to a negotiated adjustment period. These cumulative changes will move the economy toward an open trade and investment model of economic development and away from an import-substitution-industrialization economic model.

The Ministry of Economic Development and Trade of the Russian Federation requested that the World Bank undertake studies to assess the consequences of WTO accession in Russia. This has led to several studies of the likely impacts. Jensen, Rutherford and Tarr (2007) estimated that in the medium term, Russia should gain about 3.3 percent per year of the value of Russian GDP (or about $53 billion per year based on 2008 GDP at market exchange rates). In the long term, when the positive impact on the investment climate is incorporated, the gains should increase to about 11 percent per year of the value of Russian GDP (or about $177 billion per year at market exchange rates).[5] Based on the econometric estimates of the gains from an open economy trade regime, these estimated gains are very plausible.[6]

Rutherford and Tarr (2008) examined household and poverty impacts and found that virtually all households should gain from WTO accession. They find that skilled labor and urban households gain relatively more than average due to the increase in foreign direct investment in the skill intensive business services sectors. Rich households should gain less than the average household, since increased competition from foreign investment results in capital gaining less than labor. The poorest households are estimated to gain at about the level of the average household.

Given the vast geographic diversity of Russia, Rutherford and Tarr (2010) estimated how impacts would vary across the regions of Russia in a ten region model of Russia. They estimate that all regions should gain substantially, but the regions that will gain the most are those that are most successful at attracting foreign direct investment and creating a good investment climate. [7]

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[5] Russia's GDP at market exchange rates is estimated at $1.61 trillion by the World Bank; $1.68 trillion by the IMF and $1.76 trillion by the CIA, making it either the eighth or ninth largest economy in the world. Based on Purchasing Power Parity (PPP) exchange rates, Russia's GDP was $2.3 trillion in 2008, making it the sixth largest economy in the world—larger than the UK or France. At PPP exchange rates, the estimated gains per year for WTO accession would rise in the medium term to about $76 billion per year and $253 billion per year in the long term.

[6] A welfare increase of 3.3 percent of GDP is quite plausible in the context of the estimated gains from trade liberalization from econometric studies. First, Rutherford and Tarr (2002) have shown that a permanent increase of between 0.4 percent and one percent in the growth rate of an economy corresponds to a welfare increase of between 10 and 35 percent. Sachs and Warner (1995) estimate that open economies have grown about 2.45 percent faster than closed economies, with even greater differences for open versus closed economies among developing countries. They note that trade liberalization is often accompanied by macro stabilization and other market reforms, and their open economy variable can be picking up these other effects as well. But they argue that trade liberalization is the *sine qua non* of the overall reform process, because other interventions such as state subsidies often are unsustainable in an open economy. Moreover, Frankel and Romer (1999) have shown that adjusting for the simultaneity bias in cross country regression studies such as Sachs and Warner, does not reduce the estimated impact of openness on growth. More recently, using time series data on individual countries, rather than cross-country growth regressions, Wacziarg and Welch (2009) find compelling evidence that countries grow about 1.5 percentage points faster after they liberalized trade.

Rodrik, Subramanian and Trebbi (2004) and Bolaky and Freund (2008) have highlighted the importance of good institutions to economic growth. Bolaky and Freund have shown that in 25% of the countries with the worst business and labor regulations, open trade can harm growth. On the other hand, for the 75% of the countries with the best business and labor regulations, open trade has an even stronger beneficial impact on growth than previous authors have found. But Dollar and Kraay (2003) find evidence that trade is more important than institutions in the medium terms; and Rodrik, Subramanian and Trebbi have shown that trade liberalization can improve institutions while Ades and di Tella (1999) find evidence that increased trade leads to reduced corruption.

[7] They estimate that as a percent of consumption in the medium term the three regions in their model that will gain the most are the Northwest (11.2 percent), St. Petersburg (10.6 percent) and Far East (9.7 percent) while the Urals (6.2%) gains the least.

Responding to a request from the Ministry of Communications, Jensen, Rutherford and Tarr (2006) examined the impacts on the telecommunications sector of Russia. They find that skilled workers in the telecom sector will gain substantially from FDI. Russian firms that become part of joint ventures with foreign investors will likely preserve or increase the value of their investments; but Russian capital owners in the telecom sector who remain wholly independent of multinational firms will likely see the value of their investments decline. Households dependent on income from these types of firms may lose from WTO accession. Rutherford and Tarr (2008) estimate a similar distribution of the gains in the other business services sectors.

In summary, these studies indicate that Russia will reap substantial gains from WTO accession, the benefits are widespread and will reduce poverty, those regions that establish a better investment climate will reap greater gains from WTO accession, and, crucially, most of the gains are due to Russia's commitments to implement its own reforms. The commitments to implement reforms in the services sectors are the most important of Russia's own reforms that produce the gains.

These authors do not find that WTO accession will contribute positively to the diversification objective of the Russian Government. The sectors they estimate to expand the most are non-ferrous metals, ferrous metals and chemicals. While it is light industry, food processing and construction materials that they estimate are likely to contract. In the concluding section of this article, we discuss how the diversification objective can be most effectively achieved.

The estimates suggest that less than 10 percent of the gains come from improved market access for Russian exporters. After all, Russia has negotiated most favored nation status or better with all its significant trading partners. While Russian exporters will be accorded additional legal benefits in antidumping cases once Russia is a WTO member, and this is the source of the gains they estimate, many economists are cynical regarding the fairness of antidumping proceedings. This suggests that we should not expect very significant differences in determinations against Russian exporters in antidumping cases, and consequently improved market access in export markets cannot be the source of significant gains to Russia from WTO accession.[8]

Given that the benefits to Russia of WTO accession come from its own internal reforms, some infer from this fact that Russia will gain little from WTO accession—since Russia could unilaterally implement these reforms. There are several reasons why we take the opposite view—that the process of WTO accession is a unique historical opportunity to achieve reform.

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[8] In addition, members of the WTO obtain rights in international trade. Members are granted permanent most-favored nation status to the markets of other member states. So Russia will not have to be concerned about annual renewals of Most Favored Nation status. Members are also able to use the WTO's dispute settlement procedures to protect their trade interests, such as in antidumping cases. Trade disputes among WTO members are resolved based on WTO legal agreements under which smaller countries have the potential to win disputes against large countries. All WTO agreements require unanimous consent of all the members, and this helps provide a voice for the smaller member countries. On the other hand, non-members will be influenced by the new rules of this dominant organization in international trade, without a voice in their formation.

The key reason that WTO accession is important is the political economy dimension. Given the concentrated benefits to industries that achieve protection, industry groups will typically lobby for protection. On the other hand, since the benefits to consumers are diverse and less concentrated, they typically do not lobby against protection, but hope others with similar interests will lobby on their behalf. This so called “free rider problem” in political decision-making results in an absence of representation of the views of the consumer and broader economic interests in political discussions of tariffs. Lobbying and political economy considerations often allow special interests to strongly influence policy so that reforms are slow. WTO accession, however, requires across the board reform in many sectors, and the pressure of a WTO negotiation engages policy makers at the highest levels of government. Experience has shown that high- level policy-makers, who have the economy-wide interest in mind, will often intervene to impose reform on slow moving Ministries. In the case of Russia, the process began to move when then President Putin made WTO accession a priority in his first term.

We explain in the next section that it is difficult to argue that Russia would have made reforms as widespread and as deep as it has without the external pressure of WTO accession. Reforms are accomplished in the context of WTO accession that would not normally be achieved so quickly. That is, WTO bindings and external pressure make it easier for a government to adopt a trade policy designed to promote growth and poverty reduction. Moreover, unlike unilateral reforms, once a country commits to a reform at the WTO, it is bound by an international commitment that is difficult to reverse in the future by a less reform minded government. The process of negotiating bilateral market access with the countries on its WTO Working Party on Accession has led to a dramatic increase in reforms regarding the Russian trade and foreign investment regimes, and thereby has helped Russia move toward an open economy model of economic development.

III. Russian Commitments to Foreign Exporters and Investors[9]

Non-Agricultural Market Access (NAMA)

Russia agreed to reduce its bound MFN tariffs to about 8 percent on average. The calculations of Shepotylo and Tarr (2008) show that for 2005, Russia’s MFN tariffs were about 12.1 percent on a simple average basis or 14 percent on a trade weighted basis, where we have taken into account the ad valorem equivalents of Russia’s specific tariffs. Thus, a cut of the average Russian tariff to 8 percent implies a decline of about 50 percent on average.

Services Commitments

[9] The United States Trade Representative (2006) has released five “Fact Sheets” with details of Russian commitments as part the US-Russia bilateral protocol. See this source for further details.

The business services sectors have been the subject of some of the most intense negotiations associated with Russian accession. Russia has made numerous commitments in this area. Some of the key concessions are the following. Russia has agreed to increase the quota on the maximum share that foreign banks and insurance companies can attain from 15 percent to 50 percent, and Russia will phase out the prohibition on foreign participation in mandatory insurance lines. Russia reportedly agreed to terminate the Rostelecom monopoly on long distance fixed line telephone services as part of the Russia-EU bilateral agreement. (There are multinational telephone operators already operating in the Russian mobile telephone market.) Russia will ensure national treatment and market access for a wide variety of professions, including lawyers, accountants, architects, engineers, marketing specialists, and health care professionals. Foreign owned companies will be permitted to engage in wholesale and retail trade, franchise sectors and express courier services. [10] The European Union has negotiated intensely for the rights of companies other than Gazprom to construct a gas pipeline; but no success in this area has been reported.

In banking, opposition galvanized around the branch banking issue. Russia was willing to allow subsidiaries of international banks. Subsidiaries must be registered as Russian entities, and the capital requirements would be based on capital in the Russian entity. Branches, however, do not have a separate legal status or capital apart from their foreign parent bank. In general, entry into banking services in a country is easier when branches are permitted and the U.S. Treasury has been attempting to assure branch banking is permitted in all countries admitted to the WTO. The Russian central bank maintained that it could not regulate or supervise branches adequately and that depositors would therefore be at risk.

Banking interests in Russia succeeded in getting then President Putin himself to say that branch banking was a deal breaker for Russian WTO accession. Based on its bilateral agreement with the U.S., Russia succeeded in avoiding a commitment on branch banking, becoming the only non-LDC acceding country to avoid such a commitment.[11] Like many items in accession negotiations, succeeding in avoiding a commitment is a pyrrhic victory as Russia will lose the benefits from greater foreign direct investment. Nonetheless, multinational banks, operating as subsidiaries, have greater market access and national treatment rights under the bilateral U.S.-Russia agreement and Russia should benefit from greater involvement of multinational banks in Russia over time.

Agriculture Issues

Agricultural issues have been among the most contentious in Russia's WTO accession negotiations. The key unresolved issue is agricultural subsidies, which we discuss below. Russia, however, has made considerable commitments in market access as well as sanitary and phyto-sanitary negotiations. For beef, pork and poultry exports, the disputes with the U.S. were among

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[10] See Tarr (2007) for details.

[11] Russia agrees to reopen discussions on this issue upon consideration of membership in the OECD.

the most significant. Under its bilateral market access agreement with the U.S. however, Russia has made substantial concessions.

For poultry and pork products, instead of joint inspection of facilities, Russia agrees to allow the U.S. Department of Agriculture-Food Safety and Inspection Service to inspect and certify new facilities or facilities that need to remedy a deficiency. Regarding beef, Russia and the U.S. agree to timely joint inspections of all facilities that will export to the Russia. Once a joint inspection has been completed, the inspection process applying to poultry and pork exporters will apply. Additional significant commitments were made to the U.S. regarding risk mitigation for trichinae in pork and in modern biotechnology products

IV. Are There Excessive Demands on Russia Due to Political Considerations?

The allegation that demands on Russia are either political or excessive by the standards of other countries that have acceded to the WTO have been repeated frequently and have been come to be believed by many observers. We believe, however, that the evidence contradicts this allegation. Aside from a couple of well publicized cases where unusual demands were placed on Russia,[12] the demands placed are Russia are typical of the WTO accession process in the past ten years. The process of acceding to the WTO since 1998 is a difficult one in which all acceding countries have been asked to take on very significant commitments to foreign exporters and investors. In comparison with the commitments of these countries, the commitments that are reported for Russia do not appear excessive.

Goods

In goods, Russia has agreed to bind its tariffs at an average tariff level of 8 percent, after an adjustment period (USTR, 2006). This is a slightly higher average bound tariff on goods than most countries that have acceded to the WTO since 1998 (see WTO, 2005). The average tariffs for other acceding countries are: Saudi Arabia, 10.5 percent; Former Yugoslavian Republic of Macedonia, 6.2 percent; Armenia, 7.5 percent; Chinese Taipei, 4.8 percent; China, 9.1 percent; Moldova, 6.0 percent; Croatia, 5.5 percent; Oman, 11.6 percent; Albania, 6.6 percent; Georgia, 6.5 percent; Jordan, 15.2 percent; Estonia, 7.3 percent; Latvia, 9.4 percent; Kyrgyz Republic, 6.7 percent.[13] Thus, by the standards of countries that have acceded to the WTO in the last eight years that are not “Least Developing Countries,” Russia appears to have concluded market access

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[12] One unusual demand on Russia was the pressure on Russia to unify its domestic and export price of natural gas. This demand, which occupied negotiators for considerable time and was eventually dropped by the European Union, would have imposed a very high cost on Russia (see Tarr and Thompson, 2005).

[13] Two of the “Least Developed Nations” acceded with relatively high bound tariffs: Cambodia, 17.7 percent; and Nepal, 23.7 percent. But the WTO accords a preferential status to developing countries.

negotiations with bound tariffs slightly higher than average, especially in comparison to the other Transition Countries, i.e., no excessive demands from the Working Party here.

Services

In the area of services, no simple measure like an average tariff is available. But an examination of the table of commitments of the countries that have acceded to the WTO since 1998 (WTO, 2005, table 5) shows that that all of them have assumed a rather high and comprehensive level of commitments, in terms of sectors included. On a qualitative basis, a more detailed analysis of banking and insurance (Tarr, 2007) does not suggest an above average level of commitments in these important sectors. On the contrary, Russia has been able to avoid a commitment to branches of banks, unlike almost all of these countries.

Agriculture

The level of agricultural support permitted has become a major point of controversy for Russia. Russia is attempting to negotiate a high permitted "Aggregate Measure of Support" (AMS) in agriculture. We note, however, despite the increase in Russian agricultural subsidies in recent years, the de minimis level of subsidies under WTO rules should allow Russia to subsidize at its present levels or higher.

Green Box Subsidies—Unconstrained

First, the WTO allows without constraint an extensive list of subsidies in agriculture that are not considered trade distorting—the so-called "Green Box" subsidies. Green Box subsidies include a wide range of publicly funded measures including research and development, pest control, general and specialist training, extension and advisory services, inspection services for health and sanitary reasons, marketing and promotion services, infrastructure services, including electricity, roads and environmental expenditures, targeted support to low income population through food stamps or subsidized prices, direct payments to producers to support income provided it has minimal trade-distorting features, crop insurance subsidies for natural disasters, adjustment assistance through producer retirement programs and indirect income support not related to prices. The world-wide trend is to move agricultural support away from trade-distorting subsidies toward Green Box measures. In part, this is because it is generally recognized that trade-distorting subsidies are a highly inefficient way of helping agricultural producers compared with Green Box measures. And Green Box measures, which focus on research and development and agricultural services to improve productivity, are more effective at creating a competitive agricultural sector in the long run.

Amber Box Subsidies—the de minimis level

Second, trade distorting subsidies to production—the so-called "Amber Box" subsidies—are constrained; but the de minimis levels of support allow developing countries to provide state support to agriculture of up to 20 percent of the value of aggregate agricultural output. Amber box subsidies are defined as either product specific or non-product specific. For developing countries, if product specific amber box subsidies are below 10 percent of the gross value of agricultural production in the specific sector, the level of support is considered de minimis. In addition, a developing country may provide further amber box support on a non-product specific basis and have it be defined as de minimis provided the non-product specific support is not above ten percent of the gross value of aggregate agricultural production. Countries can self-classify their support between product and non-product specific support, subject only to dispute settlement, which is rarely used in this area.[14]

As part of their accession commitments, however, the countries of the former Soviet Union that have acceded to the WTO have had to agree to accept developed country de minimus limits (sometimes with an adjustment period). That is, Estonia, Lativa, Lithuania, Georgia, Armenia, Moldova and the Kyrgyz Republic have all accepted five percent limits on product specific agricultural subsidies plus and 5 percent limits on non-product specific support. Without specific knowledge of the Russian negotiations, it is likely that Russia is being pressured to accept the same smaller de minimus limits on Amber Box subsidies. If Russia were to agree to this, it would mean that independent of Russia's declaration as a developed or developing country post-accession, the de minimis level of agricultural subsidies would be developed country de minimis levels.

The Aggregate Measure of Support (AMS) and the Russian support level

Incumbent members of the WTO, like the European Union, Canada, the United States and Norway, have a base period for trade-distorting agricultural subsidies that allows more substantial trade-distorting subsidies than the de minimis levels. The precedent among acceding countries, however, is that the three year period prior to accession forms the base period for permitted trade-distorting subsidies, and trade-distorting subsidies are negotiated down from that base. Russia failed in the bilateral discussions to achieve its objective of defining 1992-1994 as the base period for trade-distorting agricultural subsidies. Russia now hopes that it will be able to negotiate about $9 billion in trade distorting subsidies.

The total value of state support to Russian agriculture in 2008 was about 163 billion rubles (or about 6.5 billion US dollars).[15] The Ministry of Finance data includes all support to agriculture, including many items that would be considered Green Box support, i.e., unconstrained support. The total value of Russian agricultural output in 2008 was 1776 billion rubles (including agriculture, hunting and, fishing).[16] Subsidies of 163 billion rubles are about nine percent of the value of agricultural output. The $9 billion in Amber Box subsidies sought by Russia is about 12-13 percent of the aggregate value of Russian agricultural output.

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[14] The de minimis levels of support for developed countries are one-half the allowed levels for developing countries. Post-accession, countries self declare whether they are developed or developing.

[15] http://www1.minfin.ru/ru/budget/federal_budget/08-10/.

[16] See the Rosstat website for this information at: http://www.gks.ru/bgd/free/b00_25/IssWWW.exe/Stg/dvvp/i000610r.htm

If Russia were constrained by developed country de minimus levels post accession, it would still be permitted the $9 billion in agricultural support, provided about $2 billion of that support is provided through Green Box subsidies. According to the reports in the press, it is likely that at least $2 billion of existing support could be classified as Green Box support.

In summary, the de minimis levels of agricultural support in Russia appear to allow Russia to subsidize agriculture at its present level of support or considerably more to the extent Green Box subsidies (which are more effective at helping farmers) are used. Thus, unless Russia seeks to use Amber Box subsidies to a significantly larger extent than at present, we do not understand why this is a crucial issue for Russia.

V. Remaining Issues in Russian Accession as an Independent Country

Often the most difficult issues remain at the end of the accession negotiations. Although Russia has resolved some of the most contentious, (such as gas pricing and branch banking where Russia achieved its objectives in the negotiations) several difficult issues remain.

The Conflict with Georgia

The conflict between Russia and Georgia regarding Abkhazia and South Ossetia has spilled over to the WTO negotiations. Georgia signed its bilateral agreement on Russian WTO Accession in 2004, then withdrew its support for Russia's WTO accession. Moreover, Georgia has objected to the agenda of the multilateral meetings and thereby blocked any formal meetings of the Working Party on Russian WTO accession. The Working Party has been meeting on an "informal basis" to make progress on Russian WTO accession. Agreement on Russia's intellectual property regime was accomplished in this manner.

Article XII of the WTO Articles on Accession states that "Decisions on accession shall be taken by the Ministerial Conference. The Ministerial Conference shall approve the agreement on the terms of accession by a two-thirds majority of the Members of the WTO."

Based on the two-thirds majority rule on accession in Article XII, Russia has apparently investigated whether it can by-pass Georgia based on this two-thirds majority rule pertaining to accessions. As a practical matter, the two-thirds majority rule is an illusion and all accession decisions are taken by consensus (by unanimity) as are all other decisions of the WTO (except dispute settlement). The Working Party would have to write a final report on Russia's WTO accession, without which the matter of Russia's WTO accession will never come to a vote before the WTO Ministerial Meeting. Just as Georgia has been able to block the Working Party from meeting, Georgia will be able to block the report from going to the Ministerial. So again, consensus is required and Georgia has a blocking vote. This implies that for Russia to accede to the WTO, Georgia will have to agree.

Agriculture

We have discussed this issue above so only briefly discuss it here. Russia is having difficulty achieving its objective of about $9 billion in permitted trade distorting subsidies. Other countries, like Kazakhstan and Azerbaijan, would like similar departures from the WTO precedent. If the Working Party allows Russia a larger trade-distorting subsidy than suggested by precedent, it will have a more difficult time negotiating previous limits with subsequent applicants for WTO membership. Australia and New Zealand are likely to resist a change in precedent that would allow an increase in the trade-distorting subsidies.

Export Taxes on Timber—Dispute with the European Union

In early 2007, the Russian government announced an increase in the export tax on timber, to be phased in over 18 months. Export taxes on softwood or poplar timber, which, in early 2007, were the greater of either 6.5 percent or 4 euros per cubic meter were progressively raised reaching the maximum of 25 percent or 15 euros per cubic meter as of April 1, 2008. The plan was to increase the export taxes further in January 2009 to the maximum of 80 percent or 50 euros per cubic meter.[17] To date, however, the Russian Government has postponed implementation of the 80 percent export tax. The increase in the export tax is part of the effort by the Russia government to diversify its industry and is intended to dramatically reduce log exports, provide cheaper inputs to the wood processors and invite foreign direct investment to develop its wood processing sector.

Finland, which is the most heavily impacted by the export tax measure, has strenuously objected to the export taxes. Sweden also opposed the export taxes. As bilateral talks with Russia failed, these two countries succeeded in getting the EU to negotiate the matter as part of Russia's WTO accession negotiations, but the issue remains unresolved. [18]

Regarding Russia's national interest in the matter, increasing value added is not a goal to be pursued at any cost. Bananas could be grown at exorbitant costs in greenhouse conditions in northern Siberia if value added were the only criterion. Rather production according to comparative advantage is the appropriate criterion. But the strong concerns from Finland, suggest that Russia has some monopoly power in its trade with Finland, and given the competitive nature of the logging industry, an export tax would be needed to exploit it.

By extending the model of Tarr and Thomson (2005), Khramov, Korableva and Kovaleva (2008) have shown that Russia does have an optimal export tax to exploit its monopoly power on exports of timber. However they estimate that the export tax is about 11.5 percent. Thus, the actual export tax applied since April 2008 is more than twice the optimum level and dramatically less than the

[17] In 2005, Russia introduced a 6.5 percent export tax on logs. As of July 1, 2007, export taxes were raised to the maximum of 20 percent or 10 euros per cubic meter. As of April 1, 2008. export taxes were raised to the maximum of 25 percent or 15 euros per cubic meter.

[18] See "Russia and Finland at loggerheads over timber taxation," International Centre for Trade and Sustainable Development. Available at: http://ictsd.net/i/news/bridges/27601/.

approximately 80 percent that is proposed for the future. When the costs to the logging industry are taken into account, the timber export tax imposes a lot more costs on the Russian economy (and the logging sector in particular) than benefits.

Rules on State Trading Enterprises

The position of the Russian negotiators is that Russia is willing to accept the usual restraints on state trading enterprises for WTO members. Russia objects, however, to demands by the U.S. for more stringent restraints on state trading enterprises.

VI. The Attempt to Accede as a Customs Union—what does it mean for Russia's trade policy in the future?

The Customs Union and WTO Accession

In June 2009, Prime Minister Putin announced that Russia would abandon its effort to join the WTO as a single country and seek membership as part of a three country customs union with Kazakhstan and Belarus. President Medvedev, however, and some officials from his office promptly indicated that single country accession was still the preferred method for Russian accession.[19] Considerable confusion prevailed in the Russian government until October 15, 2009, when Maxim Medvedkov, the lead Russian negotiator on WTO accession, announced that the three countries would seek to accede to the WTO as single countries, rather than seek accession as a customs union.

Although Russia, Belarus and Kazakhstan have returned to independent accession negotiations, Mr. Medvedkov announced that they hope to accede to the WTO on the basis of a common external tariff. That is due to be implemented from January 1, 2010. [20] The return to the negotiating table as independent countries apparently reflects the reality of the enormous complexity that negotiating as a common customs entity entails.[21] If the three countries were to jointly apply to the WTO for accession as a customs union, a new WTO Working Party on the accession of the customs union would have to be formed. This new Working Party would have to be convinced that the conditions of agreement would be applied throughout the three countries of the customs union. These commitments include, but are not limited to: commitments on bound tariffs; rights of foreign investors in services (a rather complicated area of negotiation); Technical Barriers to Trade (TBTs); Sanitary and Phyto-Sanitary Measures (SPS); Trade Related Investment Measures, agricultural trade distorting subsidies, and intellectual property

[19] See http://blog.taragana.com/n/russian-president-wto-membership-via-customs-union-with-kazakhstan-belarus-problematic-105904/

[20] See Russia Scraps WTO customs union bid, *Financial Times*, October 15, 2009. http://www.ft.com/cms/s/0/cd78250c-b9b2-11de-a7470144feab49a.html?catid=6&SID=google)

[21] In its Russia Economic Report, the World Bank (2009) warned of the difficulties of acceding to the WTO as a customs union.

commitments. This is sufficiently difficult that no customs union has acceded to the WTO, only individual countries.

The biggest problem with the October 2009 announcement is the statement, repeated by Belarusian representatives,[22] that the three countries would accede to the WTO simultaneously. Since Belarus is far behind Russia in its WTO accession negotiations, simultaneous accession would mean that Russia would have to wait, potentially many years, until Belarus is ready to join the WTO.

Mr. Medvedkov announced that the common external tariff would not violate any bound tariff agreement at the WTO, The chief negotiator for Kazakhstan, however, Zhanar Aitzhonova, implicitly acknowledged that the customs union tariff will violate commitments Kazakhstan has made in its bilateral market access agreements on its WTO accession.

Prospects for the Customs Union

As with earlier agreements on the EURASEC customs union, questions remain regarding whether the common external tariff will be implemented outside of Russia. As explained in detail in Michalopoulos and Tarr (1997a; 1997b), in EURASEC the tariff was the Russian tariff that protected Russian industry and made the other countries pay higher prices for these Russian goods compared with cheaper third country imports. Thus, implementation of the common external tariff outside of Russia was reportedly only between 50 and 60 percent of the tariff lines, depending on the country. In the current three country customs union, a formal supranational tariff setting authority should begin operating in January 2010, but the common external tariff has already been established. As in EURASEC, the tariff structure is likely heavily biased in favor of protecting Russian producers. Thus, there is reason to believe that over time, we may see a lack of implementation of the customs union common external tariff in the partner countries of Russia.

While negotiation of a common external tariff is a notoriously difficult problem in a customs union, there are areas where the members of the customs union could potentially provide substantial trade benefits to each other. Two such areas include improving trade facilitation and the reduction of non-tariff barriers. The members of the customs union could work in these win-win problems, independent of the common external tariff.

VII. Russian WTO Accession and the Jackson-Vanik Amendment

The Jackson-Vanik Amendment of the U.S. requires an annual review of Russian emigration policies in order for the U.S. to grant Most Favored Nation (MFN) status to Russia (and other former communist countries). This is a significant irritant to Russia, but the U.S. does not presently have any commercial pressure on it to remove Jackson-Vanik. Once Russia becomes a WTO member, however, there will be commercial pressure on the U.S. from its own exporters

[22] See NewsBY.org, October 19, 2009 at http://www.newsby.org/by/2009/10/19/text10968.htm.

and investors to remove Jackson-Vanik. Consequently, the U.S. will almost certainly remove Jackson-Vanik after Russian WTO accession.

The WTO requires that permanent MFN status be granted to all members. Thus, the provisions of Jackson-Vanik are inconsistent with MFN treatment required by the WTO. The U.S. has two options once Russia becomes a member of the WTO: (1) eliminate Jackson-Vanik; or (2) invoke the "non-application principle" of the WTO. For newly acceding countries, a member of the WTO can opt out of WTO commitments with respect to the newly acceding country if it invokes the “non-application” principle. If the U.S. were to invoke the non-application principle against Russia, it means that the U.S. would refuse to honor its WTO obligations to Russia. But non-application is reciprocal. So the U.S. would not have any assurance that its exporters or investors would be treated in Russia according to Russia's WTO commitments.

In practice, the U.S. has dropped Jackson-Vanik on all countries that have acceded to the WTO with one exception. In the cases of Albania, Bulgaria Cambodia, Estonia, Latvia and Lithuania, Jackson-Vanik was repealed prior to accession. In the cases of Mongolia, Armenia, Georgia, Kyrgyzstan it was repealed after accession, so the "non-application" principle was invoked, but eventually removed within a year or two. (In the case of Georgia, non-application was never invoked since Jackson-Vanik was removed soon enough after accession.) Only in the case of Moldova does Jackson-Vanik still apply to a country that acceded to the WTO.

Former U.S. Trade Representative Rob Portman testified before Congress in 2006 that the U.S. will have to lift Jackson-Vanik against Russia, Ukraine and Kazakhstan in order for the U.S. exporters and investors to gain the advantages of the commitments these countries are making at the WTO. In the case of Ukraine, Jackson-Vanik was removed in 2006.

VIII. Foreign Direct Investment

In the first ten years of transition the inflow of foreign direct investments in Russia was very low compared to Eastern European countries and the BRICs. This trend was reversed, however, around 2002-2003. As fuel prices rose, FDI flows into Russia increased tenfold over time, and Russia became one of the top countries in the world for inward FDI. By 2006, FDI inflows to Russia even passed China in per capita terms. The dynamics of Russian outward FDI also has some unusual features. Namely, the outflow is more significant than in other emerging economies and started very early in the transition.

Table 1. Inflow of Foreign Direct Investments to Russia, 2000-2008

	2000	2001	2002	2003	2004	2005	2006	2007	2008
FDI, net inflows (current billions of US dollars)	2.7	2.7	3.4	7.9	15.4	12.8	29.7	55.1	72.8
FDI as % of GDP	1.0	0.9	1.0	1.8	2.6	1.6	2.9	4.2	4.5

FDI as % of Gross Capital Formation	5.5	4.1	5.0	8.7	12.4	8.4	14.2	17.1	18.1

Sources: World Bank, World Development Indicators (2009); Central Bank of Russia

Nevertheless, starting from such a low base, the stock of FDI in Russia remains substantially less than in some important comparator countries. The accumulated stock of FDI as a share of GDP was 9.5% in 2006. This compares to 26% in China, 20% in Brazil and only slightly more than in India (7.5%).

The sectoral decomposition of inward FDI is dominated by mining and quarrying (49% in 2007) with manufacturing (17%) and real estate and business services (11%) following. The increase of FDI in the last decade was predominantly channeled into oil and gas extraction, which increased its dominant position in the stock of FDI. Geographically FDI flows are very concentrated: Moscow city got 38% in 2006; the Sakhalin region got 15% and the Moscow region followed with 10%.

The two major source countries for inflows of FDI are Cyprus (around 35% in 2006) and the Netherlands (about the same). The later is explained by the special position of the Netherlands in managing cross-border transactions in the fuel and gas sectors, and the former derives from investment by Russian nationals who have capital in Cyprus (see OECD, 2008, p.16). The next most important source country for FDI is Germany, which provided 4.4% of the inflow to Russia in 2006. In the first half of 2009 the inflow of FDI was cut in half compared to 2008, and the list of major FDI partners now includes China.

To some degree the significant increase in FDI inflows to Russia in the past seven years can be explained by its macroeconomic stability, sound fiscal policy, efficient external debt management and accumulation of foreign reserves. Infrastructure projects initiated by the state may have also indirectly attracted FDI flows. But the major factor behind the increase in FDI was the increase in the price of oil that made investments in the Russian oil and gas sectors more profitable.

While the large and expanding Russian domestic market can be attractive for foreign investors, there are several very clear risks associated with the Russian economy. The first one is the high share of output and exports in the energy sectors. Being so heavily dependent on a small number of commodities with volatile prices makes the whole economy relatively volatile. Investors may need to be compensated with higher returns to compensate for the volatility, which could reduce FDI inflows. To fight the potential risks of macroeconomic instability associated with volatile oil prices, the Government launched the Stabilization Fund of the Russian Federation in 2001.

On the other hand, in the past decade, increased government control over the economy and problems with the slow pace of regulatory and administrative reforms impede FDI. The increase in government control of the economy started with then President Putin’s first Administration. President Putin became progressively more open in establishing a dominant role for the Russian state in key sectors, including scrutiny of foreign investors in these sectors. The key piece of legislation on this was the law on strategic sectors, approved in May 2008. It defines the conditions under which foreign investment will operate in 42 strategic sectors, and requires prior authorization for the foreign investor to be able to control any business entity operating in these industries. Most of the industries on the strategic list can be aggregated in broad categories such as military and defense industries, nuclear and radioactive hazardous materials, space and aviation related sectors, subsoil exploration and exploitation and the fishery sector. The list also includes industries covered by the law on natural monopolies, large scale communication companies, TV and radio broadcasting and printing services.

The fist obvious critique of this law is the expansion of the strategic status over sectors that are not deemed to be the strategic in many economies. Some service sectors such as TV and radio broadcasting and printing are there so the state can control the major media outlets in Russia. The inclusion of the industries covered by the law "On Natural Monopolies"[23] is aimed at widening state control of the Russian economy.

While the procedures required for prior clearance of foreign investments are meticulously specified in the law, the time allowance for the official to grant the consent or declare the transaction as being a threat to country's security is quite long and variable: from four to seven months. In this respect the law differs from the practice of similar legislation in many OECD countries (OECD, 2008, p.27).

Overall, some experts point out (Gati, 2008, p.22) the positive role this law might play in attracting FDI into the economy because the conditions the investor must take into account while planning business transactions are explicitly defined. Nevertheless, by extending the limitations on foreign control to too many sectors and allowing the officials too much time to reach decisions (and time will tell if the determinations are seen as ad hoc by the foreign investment community), the law can discourage a substantial amount of potential FDI inflows.

Another potential negative effect of the law could derive from the excessive controls on subsoil exploration and exploitation. It limits the degree of risk sharing related to subsoil exploration. In an era of a very high uncertainty about volatile oil and gas prices, the risks involved in the very substantial investments in the energy field are often shared. As foreign shares of these investments will be limited, it means that greater risks will be borne by the Russian economy.

The Russian Government has also substantially expanded its role in the economy due to the emergence of state strategic corporations in energy, aircraft, shipbuilding, car manufacturing, forestry and the banking sector. State enterprises absorbed many incumbent firms in these sectors and now are often the dominant firm in the sector; these enterprises may have access to budgetary support.[24]

In many of these markets, private firms may find it difficult to compete with state enterprises that are subsidized, leading to less competition in many domestic markets-- with an inevitable decline in efficiency, higher prices and lower quality of domestic production.

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[23] These industries include pipeline delivery of oil, petroleum products or natural gas, power-station operations, railway transportation, ports and airports

[24] See Gati (2008, p.17) for a similar view.

Over the past two years, the government has changed its public stance to argue for modernization of the economy with an emphasis on foreign direct investment as the vehicle to achieve this goal. However the increase in state control of productive assets, limitations on foreign direct investment in several questionable areas, and increased use of import-substitution industrialization all work against this objective. These tendencies emphasize the internal conflicts of the current government regarding its economic policy in general and with regard to foreign direct investment in particular.

To increase the attractiveness of Russia as a destination for FDI, the Russian Government should work in several important directions. First, it needs to improve domestic institutions to make Russia a better place for doing business. Russian rankings in the Doing Business Survey and Enterprise Surveys are below the means in almost all respects and they worsened in recent years[25]. In 2009, 50% of the surveyed firms in Russia mentioned corruption as a major constraint for development. Enormous efforts should be put just to change this tendency and they involve legislative and court reform among others.

Second, important steps should be done toward making Russia a better place for locating some part of production process. It reflects the current situation with major FDI flows being vertical ones and it possesses very specific requirements not just for the business climate in the country but to a high transparency of national borders as well. In this respect Russia also falls behind its major competitors for FDI flows being ranked only 99th out of 150 countries evaluated by International Logistic Performance Index.[26] The situation with customs is especially dreadful with Russian ranking only 137th out of 150. Unfortunately customs reform was not on the list of priorities aimed at modernization of Russian economy highlighted by President Medvedev in his annual address to the Federal Assembly on November 12, 2009.

IX. Improving Customs—Any Role for Uniform Tariffs or Pre-Shipment Inspection

Given the problems in customs performance in Russia, some have recommended uniform tariffs and pre-shipment inspection services. In our view, there is enormous merit in uniform tariffs, but pre-shipment inspection services are likely to produce only marginal benefits at best.

In response to a request from the Russian Ministry of Trade, Tarr (1999) has analyzed the advantages and disadvantages of a uniform tariff for Russia.[27] Tarr (1999; 2002) argues that there is little merit for Russia in the various arguments against a uniform tariff. That is, there is

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[25] The data from the Doing Business Surveys are available at: http://www.doingbusiness.org; and the data from the Enterprise Surveys are available at: http://www.enterprisesurveys.org/CountryProfiles/

[26] The data from the Logistics Performance Index is available at: http://info.worldbank.org/etools/tradesurvey/mode1b.asp

[27] These ideas were developed further in Tarr (2002).

little merit to the argument for diverse tariffs for strategic trade policy, for optimum revenue, for exploitation of optimal power on imports, for negotiation leverage at the WTO or for balance of payments purposes. On the other hand, a uniform tariff reduces the incentive to smuggle due to elimination of the tariff peaks or to misclassify goods at customs. But by far the biggest advantage of a uniform tariff is the political economy incentive. As the experience of Chile has shown, since the uniform tariff eliminates the gains to individual sectors, it removes the incentive for industrialists to lobby for higher tariffs. So the country will get a more liberal tariff regime.

Even if there is no incentive to misclassify goods due to a uniform tariff, an incentive to falsify the valuation of the goods remains and this provides opportunities to customs officials to extract bribes. Pre-shipment inspection (PSI) is designed to deal with that problem (among others). The results for increased revenue collection from PSI, however, are not impressive. PSI delegates to a foreign private firm the valuation and some other functions. The foreign firm takes its fees (about one percent of the value of the imports). There do appear to be some increase in customs revenues, but importers often complain that they have to go to extra expenses to undergo the PSI and then customs puts them through inspections anyway. This raises the costs of delivering the goods and further erodes any benefits to the home country. Crucially, PSI does nothing for building the capacity of the home country to effectively implement a customs regime (including customs valuation), which is the real long-run goal.

X. Conclusion: Is Russian WTO accession crucial to the international community or to Russia?

Russian WTO Accession—Small Economic Gains to the International Community

We are skeptical the Russian WTO accession will convey significant benefits to the international trading community. Multi-regional trade models have shown that it is the own country liberalization that is important. That is, countries that make substantial commitments in multilateral negotiations gain more. And those that don't make commitments gain very little from the liberalization in the rest of the world. Numerous assessments of the Uruguay Round found that result (See Harrison, Rutherford and Tarr. 1997; and Martin and Winters, 1996). Harrison, Rutherford and Tarr (2002; 2004) have also found this result in multi-regional trade models of regional arrangements. In Rutherford, Tarr and Shepotylo (2005), the authors showed that Russia has dramatically more to gain from its own liberalization in WTO accession than from liberalization in the rest of the world--such as through a very successful Doha Development Agenda. Adapting the well-known computer acronym, Alan Winters has summarized these results with an acronym “WYDIWYG—what you do is what you get.” The bottom line is, notwithstanding the growing importance of Russia in world markets and the fact that some western fimrs will find profits selling or investing in Russia, it is difficult to argue that the US or the rest of the world will significantly gain economically from Russia's accession.

We believe that the US and the rest of the world would like to see Russia as a cooperating partner in dealing with international problems. And they would like to see Russia within the WTO, playing trade by the same rules, as part of that process. But this is more of a geopolitical argument than an economic argument.

WTO Accession: Unique Historical Opportunity for Reform in Russia

We have shown estimates that suggest that Russia will reap large gains from WTO accession and which show that the largest gains for Russia from WTO accession derive from its own liberalization commitments. Some will argue that if virtually all the gains come from own liberalization, why bother to go through the long painful contentious process of WTO accession, when the country can independently liberalize and achieve virtually all the benefits of accession. We would argue rather that WTO accession is a unique historical opportunity to dramatically move the country forward toward an open economy model of economic development. In a business as usual scenario, concentrated forces who want protection in their sectors will lobby to defeat liberalization, while those who gain from liberalization are diverse, and due to a free-rider problem, often do not lobby. The uneven lobbying often leads to excessive protection.

WTO accession involves foreign business interests and foreign governments in the negotiations on the level of home protection. WTO accession compels policy-makers at the highest levels of government to engage in the process and they will often impose liberalization on slow moving Ministries and sectors. Moreover, commitments at the WTO "lock-in" reform in a manner that is not easily reversed by future less reform mined governments.

Russia at the Crossroads on Trade and FDI Policy: Import Substitution Industrialization or Open Economy Development with Institutional Reform

Throughout the first decade of the 21st century, Russia has had large trade surpluses. These surpluses have exceeded $100 billion annually since 2005, giving Russia the largest trade surplus in the world in some of those years. Despite these large trade surpluses, which amounted to between 9 and 14 percent of Russian GDP since 2005 (see table 2 below), Russia has become increasingly concerned about the mineral (mainly energy) dependence of its production structure and exports, as minerals exports alone constituted 65 percent of exports in 2007. In response, the Russian Federation has increasingly employed import substitution industrialization and industrial policy for diversification of its economy or for political purposes. This includes: very high export taxes on timber to develop the wood processing industry; increased import tariffs on the food processing, light industry and automotive sectors; use of sanitary and phyto-sanitary measures for protection against meat imports from the United States and as a political tool against Georgia, Moldova (briefly) and possibly Belarus in June 2009; increases in agricultural production subsidies; restrictions on foreign investment in the Russian economy through the introduction in 2008 of the law of foreign investment in strategic sectors; and the creation of a grain marketing board with unclear objectives. Many of these actions would be constrained by WTO rules or commitments. Thus, Russian leaders may wish to more actively use industrial policy and import-substitution-industrialization, and now see the WTO rules as counterproductive to Russian development.[28]

Diversification of the Russian economy is a worthy goal. However, to achieve diversification, institutional reform to improve the business climate is necessary. Russia rates badly on measures of institutional development. For example, it ranks 120 out of 183 on the Doing Business index; 99 out of 150 on the Logistics Performance Index; and 147 out of 180 on the Transparency International Corruption Perceptions Index. Small and medium enterprises depend crucially on the institutional environment for doing business. The incredibly rapid improvement of Georgia in the past eight years (now ranked 11th in the world on the ease of doing business) has shown that very rapid progress is possible in institutional performance when a concerted effort is made starting from the highest levels of government.

[28] Aslund (2007) has elaborated the stiffening of political will in Russia on WTO accession.

Table 2. Trade balance of Russian Federation, 2000-2008 (in billions of current US dollars)

	2000	2001	2002	2003	2004	2005	2006	2007	2008
Exports	114.6	112.7	120.9	152.1	203.8	268.8	334.6	393.8	522.9
Imports	61.1	73	84.5	103.2	130.7	164.2	209	282.5	368.2
Trade balance	53.5	39.7	36.4	48.9	73.1	104.6	125.6	111.3	154.7
Trade balance as a percent of GDP	20.6	12.9	10.5	11.3	12.4	13.7	12.7	8.6	9.6

Sources: Rosstat; World Bank, World Development Indicators (2009).

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